Economics

A LEVEL

Economics

Teacher Guide on Preparing with Pre-Release Materials

September 2014

OCR
Oxford Cambridge and RSA

CONTENTS

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SECTION 1– PREPARING STUDENTS TO USE PRE-RELEASE MATERIAL IN ECONOMICS

The main purpose of pre-release materials is to encourage candidates to "think like economists" when presented with data. Candidates are given the opportunity to explore and examine issues in depth, applying their understanding of economic theory and their "economists' toolkit" to a topical situation.

Students are usually well motivated for activities relating to pre-release materials, as they realise that tasks related to the materials are directly relevant to their examination. The materials act as a focus for the revision of topics already covered and also for learning topics not yet taught.

This guide provides a range of approaches to the use of pre-release material. This first section proposes general strategies for teaching and learning which can be used with any pre-release material. It is accompanied by an annotated example of OCR pre-release materials from June 2014, of suggested analysis activities for this specific stimulus material which teachers can adapt for future pre-release materials. Details of these analysis activities are also provided in section 2 below.

USING THE "INTRODUCTION" SECTION OF THE MATERIALS

The introduction to the materials shows candidates the main themes in the materials and the broad topic areas to be covered. The themes are the economic issues arising from the pre-release materials, whilst the topics are the specific items from the specification which relate to the themes under consideration. Working individually, students should:

Read the introduction

Identify the themes

Identify the topic areas

Students should then share their findings in a group or whole class discussion, which should be guided by the teacher to ensure that no main points are missed. Following the discussion, students should create their own individual notes or mind maps of the themes and topics.

A further activity which has proven successful is to dedicate a display area in the classroom to the pre-release themes and topics. Once these have been identified, individual students or pairs are tasked with illustrating one theme or concept on a sheet of A4 paper. The illustrations are then placed in the centre of the display area. Each week, as themes and topics are analysed in more depth, further illustrations are added to the display. The display thus grows and develops in an organic fashion to create a graphical reminder of all the themes and topics related to the materials. As it is permanently on view, students can refer to it regularly to remind themselves of issues arising and the links between them. The display thus becomes a highly effective tool for revision.

MAPPING THE SPECIFICATION

The OCR specification is presented in two columns. The subject content and concepts appear on the left hand side, whilst on the right hand side are the assessment outcomes i.e. what candidates are expected to be able to do in the examinations. One of the most useful activities to do with the pre-release materials is to map out the relevant concepts and assessment outcomes on a grid like the one below.

Extract Number	Paragraph	Content / concept	Assessment outcome	Assessment objective

Extract number – each of the extracts is numbered, so the first thing to do is to show the location of the issue in question.

Paragraph – if the paragraphs within each extract are not numbered by OCR, the teacher should do this and share the numbering system with all candidates, so as to provide a shorthand way of referring to the location of an item.

Content / concept – taken from the left hand side of the specification, this refers to the topic linked to a particular paragraph.

Assessment outcome - taken from the right hand side of the specification, this shows for each topic what candidates should be able to do.

Assessment objective – this shows the assessment objective addressed by each assessment outcome.

The completed grid fulfils a number of functions:

- It encourages candidates to make a detailed scrutiny of the materials
- It provides a structure for more detailed analysis
- It identifies the specific topics which need to be covered, either through revision or teaching from scratch, depending on the topic and the teacher's work prior to the issue of the pre-release materials
- It highlights the assessment-related skills which candidates will need to practise for each topic
- For the teacher, it becomes a useful tool for planning teaching and learning activities.

A range of strategies can be adopted in order to complete the grid: all strategies will require the teacher and students to have individual copies of the specification. The teacher could produce a definitive version of the grid. Each student could produce their own version of the grid. Each student could be given a paragraph or number of paragraphs to analyse, then report back to the class. Students could be divided into groups and the groups could then be given a number of paragraphs or a whole extract to analyse, then report back to the class. Individual students or groups of students could be allocated certain topics from the specification and then tasked with finding where in the pre-release materials those topics might be applied. The teacher will select the strategy or combination of strategies most appropriate to their individual strengths and to the characteristics of each teaching group. The candidates should be informed that the first version of the grid is likely to change, as further work on the materials is likely to reveal other topics which become relevant during the analysis. It is therefore expedient to produce the grid using a computer, so that additions and alterations can be made.

The grid becomes the basis for using theoretical concepts to analyse the materials. Extract by extract, each topic can be applied to the pre-release materials and candidates can study how the topics apply and how they link to each other. Sample activities that could be adapted and used for this purpose are shown in "Section 2 – Analysis Activities" below and on the annotated stimulus materials from June 2014.

SECTION 2 – ANALYSIS ACTIVITIES

This section contains suggestions for activities which could be used in the analysis of the pre-release materials. The activities are general in nature and can be used with any pre-release materials. Specific examples of these activities are shown in the annotated version of the stimulus materials from June 2014.

Creating a glossary – candidates should read through the pre-release materials and highlight or underline economic terminology. Where the terminology is new to them, candidates should research definitions and create a glossary of terms [see June 2014 Stimulus Material Introduction].

Summarise key points – candidates should read the extract, select the key points and make a brief written summary of these points [see June 2014 Stimulus Material Extract 1].

Researching trends – candidates should research trends in key economic indicators relating to the pre-release materials, in order to see historical trends and to find data more recent than that in the extract, so as to be able to comment effectively on the trends [see June 2014 Stimulus Material Extract 1].

Role play – candidates could take on the role of members of an economic institution, or the class could be divided into households, firms and government and asked to give their account of the effects of issues raised in an extract [see June 2014 Stimulus Material Extract 1].

Holding a class debate – where the extract contains "either / or" choices of solutions to economic issues, a debate could be organised to explore the relative merits and drawbacks of the options or proposals [see June 2014 Stimulus Material Extract 1].

Analysing graphical information – the basic technique is to look for and comment upon highest and lowest points, then to analyse trends and exceptions to those trends [see June 2014 Stimulus Material Extract 2].

Producing policy proposals – candidates can be asked to analyse a situation and then make written suggestions as to how the situation ought to be managed [see June 2014 Stimulus Material Extract 2].

Giving a presentation – candidates can be given the task of undertaking further research into an issue and then making a presentation of their findings to the class [see June 2014 Stimulus Material Extract 2].

Conducting further research – it may be useful to candidates to conduct more detailed research of a certain issue in order to clarify the situation [see June 2014 Stimulus Material Extract 3].

Questions for discussion – in order to develop candidates' understanding, the teacher may find it useful to produce questions for discussion which can be used by pairs, small groups or the whole class [see June 2014 Stimulus Material Extract 3].

Making a fact file – in the case of countries with which candidates are unfamiliar, it can prove interesting to create an economic fact file about that country [see June 2014 Stimulus Material Extract 4].

Further explanation – when presented with certain concepts, particularly those which fall outside the broad content of the specification, the teacher may wish to provide further explanation [see June 2014 Stimulus Material Extract 4].

Writing a report – as a way of processing information about a complex situation, candidates could be asked to write a report [see June 2014 Stimulus Material Extract 5].

Creating posters of possible solutions – where the extract contains details of problems facing specific economies, candidates often find it useful to discuss possible solutions and then create posters illustrating those solutions [see June 2014 Stimulus Material Extract 5].

Using a variety of activities in order to analyse the pre-release materials will help to maintain student interest and keep them curious about what will happen each lesson. The breadth of activities allows teachers to select those activities most suited to their individual teaching approach and to the specific groups that they teach.

ASSESSMENT OUTCOMES

Candidates also need to practise and refine their examination skills through the use of relevant questions based on the potential assessment outcomes. By way of example, below are generic questions based on the assessment outcomes described on the right hand side of the 2008 specification for Economics. These questions can be adapted according to the specific content of the pre-release materials.

AO1 – demonstrate knowledge and understanding of specified content

Describe the characteristics of globalisation

Define terms of trade

Outline the pattern of global trade

Distinguish between absolute and comparative advantage

Describe the limitations of GDP as a measure of development

Describe the limitations of HDI as a measure of development

Distinguish between growth and development

Describe the common features of economies as they develop

Describe the different stages of the economic cycle

Distinguish between short run and long run economic growth

Define the multiplier

Describe policies to promote economic stability

Describe policies to promote economic growth

AO2 – apply knowledge and critical understanding to problems and issues arising from both familiar and unfamiliar situations

Explain the stages of economic integration

Explain examples of economic integration such as the EU, NAFTA and ASEAN

Explain the factors promoting globalisation

Explain how exchange rates are determined in different exchange rate systems

Explain purchasing power parity

Explain the role of the WTO

Explain the role of the IMF

Explain the role of the World Bank

Explain what determines the size of the multiplier

Explain the relationship between growth and development

Explain the meaning of sustainable economic development

Explain the use and limitations of indicators such as GDP and the ISEW in measuring sustainable economic development

AO3 – analyse economic problems and issues

Analyse the effects of international trade

Analyse the causes of imbalances on the balance of payments

Analyse changes in the terms of trade

Analyse the influences on the different flows of international finance

Analyse the social, environmental, resource and demographic impacts of growth at different stages of development

Analyse the nature and significance of output gaps

Analyse the significance of policy rules, targets and constraints in promoting economic stability

Analyse the significance of policy rules, targets and constraints in promoting economic growth

Analyse the significance of policy rules, targets and constraints in promoting international competitiveness

AO4 – evaluate economic arguments and evidence, making informed judgements

Macroeconomic performance

Discuss the causes of economic growth in the short run and long run

Discuss the interaction of the multiplier and accelerator as determinants of the economic cycle

Discuss the consequences for inflation of economic growth

Discuss the consequences for unemployment of economic growth

Comment on the consequences of economic growth on the balance of payments

Comment on the consequences of economic growth on the government's fiscal position

Discuss the effectiveness of policies to promote economic stability

Comment on the effectiveness of using monetary policy to promote growth

Comment on the effectiveness of using fiscal policy to promote growth

Comment on the effectiveness of using supply side policy to promote growth

Discuss the effectiveness of policies to promote international competitiveness

Comment on the significance of policy rules, targets and constraints in promoting economic stability

Comment on the significance of policy rules, targets and constraints in promoting economic growth

Comment on the significance of policy rules, targets and constraints in promoting international competitiveness

Trade and integration

Comment on comparative advantage as an explanation of global trade patterns

Comment on the relative merits and drawbacks of different exchange rate systems

Discuss the causes and consequences of exchange rate fluctuations

Comment on policies to correct imbalances on the balance of payments

Discuss the case for and against protectionism

Discuss the internal and external consequences of economic integration

Development and sustainability

Discuss the effectiveness of policies to promote development

Discuss the role of international trade and economic integration in promoting development

Discuss the relative importance of internal and external constraints on development

Discuss the usefulness of indicators in policy-making contexts

Discuss the usefulness of national and regional policies and international agreements to promote sustainability

The economics of globalisation

Discuss the impact of multinational firms

Comment on the effects of different flows of international finance

Discuss the impact of globalisation

Comment on the issues surrounding current international trade negotiations and trade disputes

The questions can be used in a wide variety of ways to develop candidates' skills. They can be used as a basis for paired, small group or whole class discussion. Selected questions can be used to create exemplars of techniques for answering. They can be used to give candidates the opportunity to look at causes and consequences and build chains of reasoning. Candidates can practise the skill of making essay plans. Some questions could be set for homework, whilst others could be done in class under timed conditions. In both cases, there would be the opportunity to use peer assessment and / or self assessment. Teachers could research past papers for similar questions and use the mark schemes from such questions as part of the assessment process. Teachers may wish to reserve relevant questions from past papers, together with their mark schemes, to use for mock examinations.

The combination of analysis activities and activities based on assessment outcomes will allow candidates the opportunity to develop skills in all four of the assessment objectives, with a clear focus on the higher order skills of analysis and evaluation. Careful selection from the activities outlined above should ensure that candidates gain maximum benefits from their study of the pre-release materials.

ANNOTATED PRE-RELEASE JUNE 2014

OCR

To be opened on receipt

A2 GCE ECONOMICS

F585/01/SM The Global Economy

STIMULUS MATERIAL

JUNE 2014

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INSTRUCTIONS TO CANDIDATES

- This copy must **not** be taken into the examination room.
- You should make yourself familiar with the stimulus material before you take the question paper. A clean copy of the stimulus material will be given to you with the question paper.

INFORMATION FOR CANDIDATES

- The following stimulus material has been adapted from published sources. It was correct at the time of publication and all statistics have been taken directly from the published material.
- This document consists of **16** pages. Any blank pages are indicated.

Turn over

2

Introduction

The International Monetary Fund (IMF) has a number of roles and responsibilities, including surveillance. In 2012 the IMF concluded its annual assessment of the UK economy which, whilst supporting the UK Government's policy of austerity, made policy recommendations which it thought were necessary to secure a sustained economic recovery in the UK. These policy recommendations focused on the need to ensure that fiscal austerity did not reduce aggregate demand and hold back economic growth. The IMF thought that the UK output gap needed to be closed and was concerned that fiscal tightening might have a long term impact on the productive potential of the economy. It recommended that the UK Government should consider policies of balanced budget fiscal expansion and a loosening of monetary policy. The UK Government responded to this assessment of its economic policy by saying that expansionary policies should not conflict with the objectives of reducing the budget deficit and national debt. Later in 2012 the IMF published research which suggested that fiscal multipliers in a number of countries were much higher than previously thought and estimated these to be in the range of 0.9 to 1.7

In comparison to its lukewarm support of fiscal austerity in the UK, the IMF was full of praise for the results of fiscal austerity in Latvia. IMF support for Latvia had previously been conditional upon a substantial tightening of fiscal policy. Despite Latvia operating a fixed exchange rate against the euro, the IMF claimed that Latvia had been able to restore its international competitiveness through cutting wages and prices. Fiscal austerity had helped achieve this improved international competitiveness through large cuts in public sector wages and the deflationary consequences of fiscal tightening on the private sector. The consequence was that, even though Latvia's nominal effective exchange rate (NEER) had been broadly stable, its real effective exchange rate (REER), adjusted for changes in unit labour costs, had depreciated by around 20% since the end of 2007. Not all economists, however, agreed that such 'internal devaluation' was the best way for an economy such as Latvia's to deal with its external imbalances. These economists drew a comparison with Iceland which operated a floating exchange rate. Its exchange rate had depreciated by 50% since the end of 2007.

Nevertheless, the IMF was strong in its support of Latvia's intention to adopt the euro. It felt that this would bring benefits to the Latvian economy in both the short run and the long run

The trend towards fiscal austerity raised fears that the global economy was heading towards recession. The United Nations Conference on Trade and Development (UNCTAD) expressed a view that fiscal austerity in developed economies would put at risk the gains in economic development in the developing world through its impact on international trade. However, the experience of resource-rich economies in sub-Saharan Africa seemed to contradict this view. Commodity exports had grown strongly despite the downturn in economic growth in developed economies. Trade in commodities remained an important contributor to economic development for resource-rich economies in sub-Saharan Africa. Despite this, there were some concerns about the extent to which economic development in such economies could be promoted solely by a reliance on international trade.

Students should highlight words and phrases with which they are unfamiliar and create a glossary of key terms from the pre-release materials [see first paragraph below].

Paragraph 1: theme - austerity; topics - policy issues, policy rules, targets and constraints.

Paragraph 2: theme - international competitiveness through internal devaluation; topics - exchange rate systems, exchange rate fluctuations.

Paragraph 3: theme - the Euro; topic - economic integration.

Paragraph 4: theme - impact of austerity measures on international trade; topics - international trade, constraints on development.

Pre-release stimulus material

Extract 1: IMF surveillance report on the UK economy

Extract 2: Fiscal austerity and the UK output gap

Extract 3: IMF praise for fiscal austerity in Latvia

Extract 4: Latvia and Iceland – internal devaluation versus exchange rate devaluation

Extract 5: Economic development in resource-rich economies in sub-Saharan Africa

Turn over

Extract 1

IMF surveillance report on the UK economy

One of the IMF's main roles is 'surveillance'. This takes the form of an annual assessment of the economic situation in each member country. Officials from the IMF conduct a detailed analysis and then make forecasts of economic performance which are followed by in-depth discussions with a country's government and central bank. The IMF believes that such 'surveillance' encourages member countries to adopt sound economic policies.

The IMF's 2012 annual assessment of the UK made comments on the country's economic situation (Fig. 1.1). The IMF also made policy recommendations which it thought were necessary to secure a sustained recovery in the UK (Fig. 1.2).

1. **Current policies are aimed at assisting economic rebalancing and financial sector stability.**
   Strong fiscal consolidation is under way and reducing the high structural deficit over the medium term remains essential. The UK has made substantial progress towards achieving a more sustainable budgetary position and reducing fiscal risks. Bold monetary stimulus has helped support the economy, as has the free operation of automatic fiscal stabilisers.

2. **But the economy has been flat.**
   The rebalancing from public sector to private sector demand-led growth has not fully materialised. UK output remains more than four percentage points below its 2008 peak. Encouragingly, labour market performance has been better, with fewer employment losses than in the aftermath of previous major UK recessions. But unemployment at 8.2%, with a large number of young people without a job, is still much too high.

3. **The recovery is expected to gain pace, but much productive capacity could remain idle for an extended period.**
   Despite the projected modest increase in growth in the second half of 2012, the UK output gap is projected to remain sizeable for an extended period, raising the risk of hysteresis as sustained cyclical weakness may reduce the economy's future productive capacity.

4. **Inflation is falling.**
   Inflation has been on a downward trend since peaking in September 2011. This trend will continue as the large output gap exerts disinflationary pressure. Thus inflation is expected to decline below the two percent target over the next 18–24 months. This is dependent on an unchanged macroeconomic stance and an absence of a sustained increase in commodity prices.

5. **Risks are large and tilted clearly to the downside.**
   Setbacks in the euro area are the key risk to economic prospects and financial stability in the UK as trade and financial links are substantial. Another risk is that the adverse impact of measures to reduce public and private sector debt may be even larger than expected and the anticipated rebalancing of demand is even slower to materialise. Commodity price volatility also remains a risk for both inflation and growth.

Fig. 1.1 – Selected comments from the IMF on the economic situation in the UK

5

1. **Policies to bolster demand should help close the output gap faster.**
It needs to be recognised that policy options in this regard come with risks, including uncertainty about their effectiveness. However, these risks need to be weighed against that of weak demand leading to long run slow growth, high unemployment and a negative impact on consumer and investor confidence.

2. **A more expansionary monetary policy is required via further quantitative easing and possibly cutting the interest rate.**
Weak nominal wage growth and broadly stable inflation expectations suggest underlying inflationary pressure is weak, providing space for a more expansionary monetary policy.

3. **A more expansionary fiscal policy should be considered if downside risks materialise and the recovery fails to take off.**
Balanced budget fiscal expansion should be pursued to increase growth. For example, cuts in spending on items such as public employee wages could be used to finance higher spending on items such as infrastructure.

Fig. 1.2 – Selected IMF fiscal and monetary policy recommendations for the UK

The IMF annual assessment of the UK's economic situation reignited debate about the effectiveness of the Coalition Government's Deficit Reduction Plan. There was a stark contrast between the statements of the Managing Director of the IMF, Christine Lagarde, and the UK Chancellor of the Exchequer, George Osborne.

"Unfortunately the economic recovery in the UK has not yet taken hold and uncertainties abound. The stresses in the euro area affect the UK through many channels. Growth is too slow and unemployment... is too high. Policies to bolster demand before low growth becomes entrenched are needed."

Christine Lagarde

"The IMF couldn't be clearer today. Britain has to deal with its debts and the Government's fiscal policy is the appropriate one and an essential part of our road to recovery. I welcome the IMF's continuing support for the UK Government's Deficit Reduction Plan."

George Osborne

A class debate could be organised around the following statement: "This house believes that the current austerity policy is too damaging to the UK economy and should be replaced by Keynesian demand management measures."

Candidates could role play IMF members presenting their report and members of the UK Government responding to it.

This extract contains a great deal of information, candidates should therefore summarise the key points before going on to analyse the points.

The extract gives the IMF's view of UK economic performance, including for example unemployment in Fig. 1.1 point 2, inflation in Fig 1.1 point 4 and economic growth in Fig. 1.2 points 1 and 3. Candidates should research more recent data for these indicators to see whether or not the IMF forecast was accurate.

6

Extract 2

Fiscal austerity and the UK output gap

The first official estimate of UK Gross Domestic Product (GDP) for the second quarter of 2012 sharpened the focus on the UK's weak economic performance. Figures released by the Office for National Statistics (ONS) showed that GDP had declined by 0.7% between April and June. This represented the biggest quarterly fall in UK output since early 2009.

Predictably, some economists saw this as further evidence of a need for the UK Government to change the direction of economic policy away from austerity and towards the direct stimulation of economic growth. Others doubted the reliability of the estimates of GDP, pointing out that unemployment continued to fall, tax revenues were increasing and that business surveys showed rising rather than falling economic activity. They argued that the Government should not be distracted from its commitment to reduce the budget deficit and national debt. The head of the Organisation for Economic Co-operation and Development (OECD), Angel Gurria, echoed the assessment of the IMF that measures to promote growth should concentrate on balanced budget fiscal expansion.

The extent of the UK's weak economic performance can be seen in Fig. 2.1. This compares the change in GDP from the start of the 2008 recession with the next most recent recession (1990–93) and what is considered to be the worst recession (1930–34).

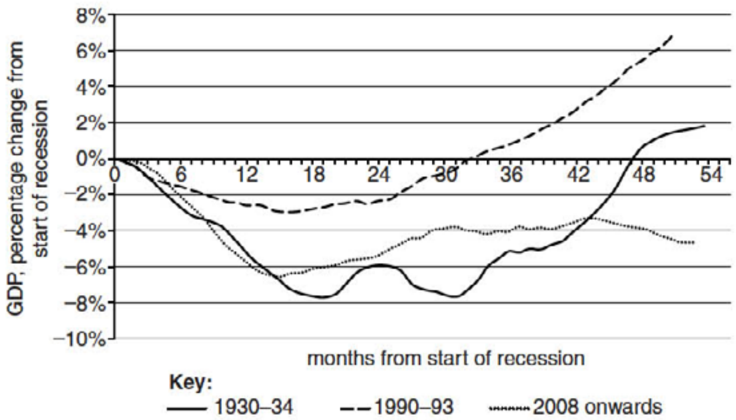

Fig. 2.1 – A comparison of the change in GDP in three UK recessions

The case for more fiscal and monetary stimulus would be a strong one if the UK output gap was large. In all previous recessions, UK output had returned to its pre-recession level within 48 months of the start of the recession. This was clearly not the case with the recession which started in 2008. There was agreement that the UK's output gap in 2012 was negative. However, estimates of the size of the output gap varied from –2.5% of GDP (Office of Budget Responsibility) to –9% of GDP (Centre for Business Research, University of Cambridge).

 F585/01/SM Jun14

Candidates should be required to analyse this data, identifying the highest and lowest levels of change in GDP in each of the recessions, the overall trend in each recession and any exceptions to the identified trends. Candidates should then compare the recessions.

Candidates could be asked to draft a policy statement for alternatives to austerity, should it be the case that the UK in 2012 had a large negative output gap.

The class could be split into two groups, each group having to prepare and give a presentation. One group could present the case for continuing with austerity measures whilst the other group could put the case for more expansionary measures. The presentation would bring together issues from the other analysis activities for Extracts 1 and 2 and allow candidates to form an overall conclusion.

Extract 3

IMF praise for fiscal austerity in Latvia

In December 2008 the IMF announced plans to lend €1.7 billion to Latvia to help to stabilise its economy. This financial assistance was supplemented by loans from the European Union (EU), the World Bank and several Nordic countries to provide a package totalling €7.5 billion. The assistance was part of an agreement to defend Latvia's currency peg to the euro (a fixed exchange rate) and the country's commitment to join the euro. The Latvian currency, the lat, had come under pressure as a result of a current account deficit on the balance of payments of almost 25% of GDP in 2007. This deficit was financed by increasing levels of private sector external debt. The credit and growth boom that followed Latvia's accession to the EU simply could not be sustained. Very high wage growth, far in excess of productivity growth, had severely undermined Latvia's international competitiveness and contributed to the economy's large external imbalances. Latvia was once the fastest growing economy in the EU. By the end of 2008 it was the worst-performing economy.

In exchange for financial assistance from the IMF and other lenders, Latvia agreed to a 'strong package of policy measures' including:

- large cuts in public sector wages
- substantial tightening of fiscal policy
- structural reforms to raise international competitiveness.

IMF staff visited Latvia in May 2012, as part of its surveillance role, in order to monitor the outcome of its programme of assistance and the policy measures adopted by the country. In a press release, the IMF concluded that:

"The Latvian authorities have made good progress toward the programme's strategy of euro adoption. Impressive fiscal consolidation during the programme means the Maastricht fiscal criteria should be easily met. Joining the euro would be beneficial for the Latvian economy."

The IMF's assessment of the outcome of its programme of assistance and the policy measures adopted by Latvia were held up as examples of the success of fiscal austerity measures. Latvia had rejected devaluation of the exchange rate in place of a policy of 'internal devaluation' to restore international competitiveness. Latvia is one of four economies, known as the BELLs (Bulgaria, Estonia, Latvia and Lithuania), which adopted and stuck to a fixed currency peg with the euro and have been regarded as success stories of fiscal austerity. The fiscal tightening in Latvia initially produced a loss of output of around 20% and an increase in unemployment from 6% to 18.4%. However, by 2011 the country's current account deficit had become a surplus and GDP growth, at 5.5%, was one of the highest in the Europe.

In a speech in Riga, Latvia's capital, in June 2012, Christine Lagarde, Managing Director of the IMF, was full of praise for the country's policy of austerity. She praised the Latvian government's economic policy as a "success story" that "could serve as an inspiration for European leaders grappling with the euro crisis". Fig. 3.1 gives extracts from her speech.

It is a great pleasure to be here today in this beautiful city of Riga to celebrate the remarkable achievements of Latvia over the past few years.

Let me begin with the context. As you all know too well, Latvia has been tested severely over recent years. It lost a fifth of its output in just two years, 2008 and 2009. Unemployment rose to almost 20%, and double this rate among young people. Poverty increased and people from all walks of life endured great suffering.

And yet, while challenges remain today, you have pulled through. You have returned to strong growth and reduced unemployment, even if it remains far too high at around 16%. You have lowered budget deficits and kept government debt ratios to some of the lowest in the European Union. You have become more competitive in world markets through wage and price cuts. You have restored confidence and brought down interest rates through good macroeconomic policies.

How did you do it?

If we want to single out one factor for Latvia, it would be its impressive determination. This had a number of dimensions:

- *instead of spreading the pain over many years, the country stood together and did what needed to be done up front. The achievement was incredibly impressive – in the first year of its programme, Latvia implemented fiscal adjustment of more than 8% of GDP. Total adjustment for the whole programme is even higher, at around 15% of GDP.*
- *Latvia also had a clear goal: euro adoption. This meant that everybody knew where they were going, and Latvia has stayed the course.*
- *to cushion the hardship, the government agreed to protect the poorest and most vulnerable people by strengthening the social safety net. So, even in an atmosphere of major budget cuts, Latvia expanded and improved unemployment assistance.*

Speaking for the IMF, I am proud to have been part of Latvia's success story, alongside our European Commission and Nordic partners.

Fig. 3.1 – Selected quotes from a speech by Christine Lagarde

  Turn over

In order to tease out the implications of this Extract and the follow on from it in Extract 4, the teacher could produce a series of questions for discussion.

There is definitely a case here for candidates to do further research into the performance of the Latvian economy and into the topic of fixed exchange rates.

10

Extract 4

Latvia and Iceland – internal devaluation versus exchange rate devaluation

Some economists are sceptical about the success of Latvia's internal devaluation in delivering a sustained economic recovery and correcting external imbalances.

Although Latvia's GDP has grown since 2010, it is not clear that such growth can be sustained. This is because of the sharp change in the composition of GDP growth which has resulted from internal devaluation. High levels of private sector indebtedness remain in Latvia and, as a result, growth in both investment and consumer expenditure remain weak (see Fig. 4.1). Fiscal tightening has limited the contribution of government expenditure to GDP growth. Latvia's economic growth is, therefore, very heavily dependent on growth in net trade. Whether Latvia can sustain economic growth solely from exports depends not only on the growth in world trade but also on Latvia's international competitiveness.

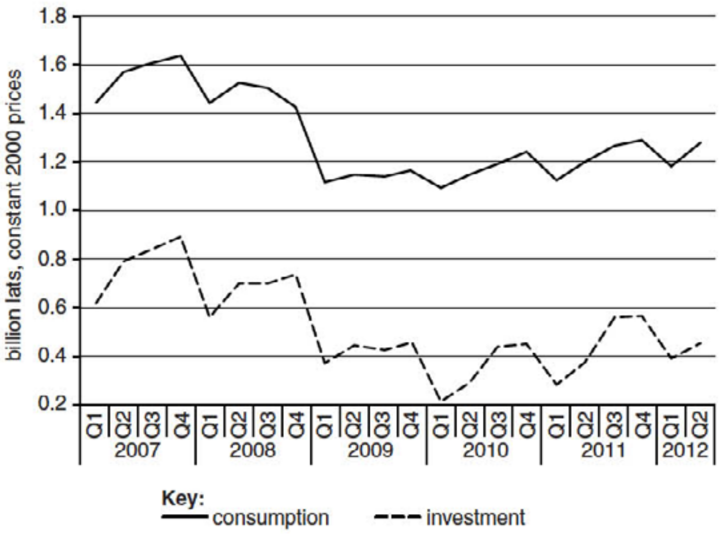

Fig. 4.1 – Latvian investment and consumer expenditure (billion lats, constant 2000 prices)

Internal devaluation puts downward pressure on nominal wages and prices and has been responsible for restoring some of Latvia's international competitiveness which was lost prior to 2007. However, most of the reduction in nominal wages occurred in the public sector and not in the private sector. In addition, for reductions in unit labour costs to be sustained, there needs to be improvements in productivity as well as a reduction in nominal wages. The improvement in Latvia's current account balance has been short lived. The surplus recorded in 2010 disappeared and by 2012 a deficit on the current account re-emerged.

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Unless students were already familiar with the economies of Latvia and Iceland, it would be both useful and interesting for them to compile a fact file about each country, to provide background to the Extract and to give a basis for comparison.

11

Economists who are sceptical about the success of Latvia's internal devaluation in delivering a sustained economic recovery and correcting external imbalances draw a comparison with the experience of Iceland. Unlike Latvia, Iceland has a floating exchange rate. Iceland's nominal effective exchange rate (NEER) index depreciated by almost 50% after the end of 2007. In comparison, Latvia's NEER was broadly unchanged (see Fig. 4.2). Latvia was more dependent on a change in its real effective exchange rate (REER), which depreciated by around 20% measured in terms of unit labour costs. This compares to a 45% depreciation in Iceland's REER based on changes in unit labour costs. In addition, Iceland's fiscal tightening was not as aggressive as Latvia's. Fig. 4.3 shows the different outcomes from 2007 until 2012 in the two economies of the different approaches to the problem of external imbalances.

This extract contains concepts which are unlikely to have featured in the teaching of F585 topics and are yet essential to understanding Extracts 3 and 4. The teacher would need to provide further explanation and clarification of the concept of internal devaluation and the difference between the NEER and the REER.

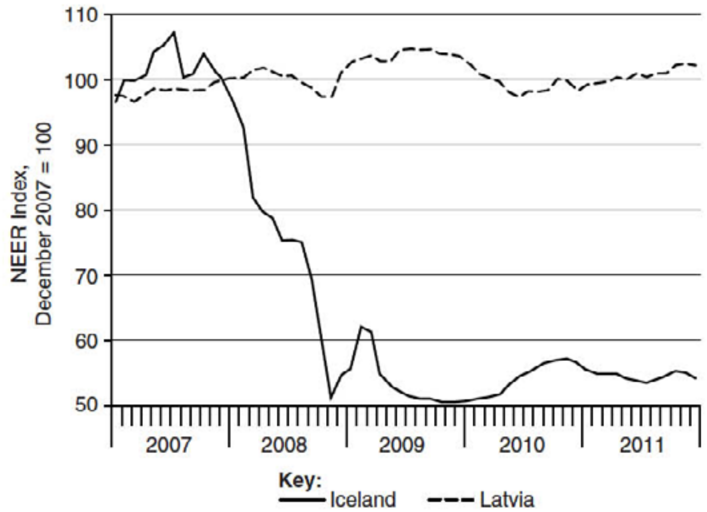

Fig. 4.2 – Nominal Effective Exchange Rate Indices for Iceland and Latvia, 2007–11

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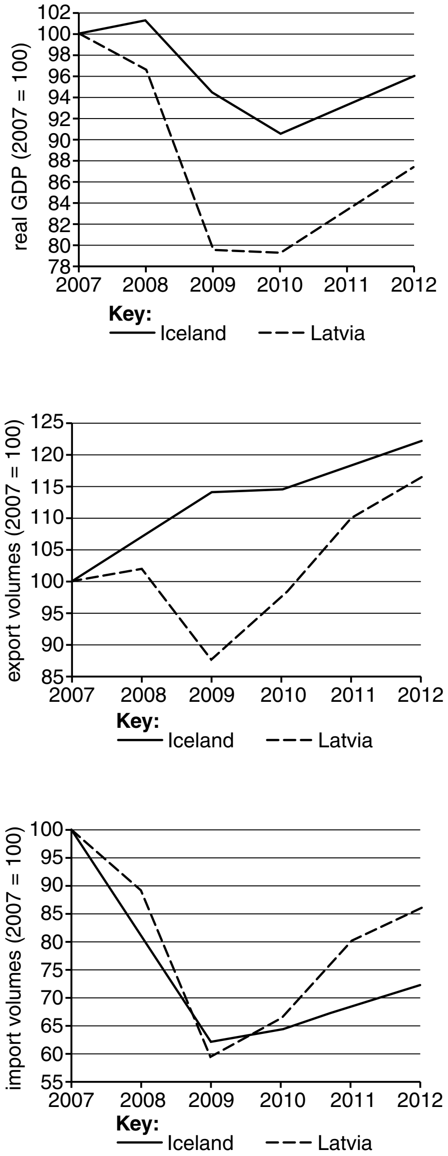

Fig. 4.3 – A comparison of key economic indicators in Iceland and Latvia, 2007–12

Extract 5

Economic development in resource-rich economies in sub-Saharan Africa

At the end of 2011 the United Nations Conference on Trade and Development (UNCTAD) warned that fiscal austerity policies being implemented by European countries were driving the global economy towards a recession. In a policy brief published in December 2011, UNCTAD stated that:

"A fragile global economy has a significant interest in the implementation of expansionary, rather than contractionary, fiscal policies in key economies. Only the former can open a path towards lower fiscal deficits and falling public debt ratios. A 'lost decade' for the world economy would risk the development gains achieved during recent years."

This contrasted with an assessment by the IMF in April 2012 of the economic outlook in sub-Saharan Africa (SSA). According to the IMF the fall in economic activity in Europe had not had a significant impact on growth in most of SSA. This was because most countries in SSA had diversified their exports to emerging markets and intra-regional trade had increased. In addition, around 80% of exports from SSA were commodities. Between 2005 and 2010 the region's commodity exports had grown in total by 16.6%, but exports of commodities to Europe had only grown by 2.6%.

Exhaustible natural resources account for a large share of output and export earnings in many SSA countries. Fig. 5.1 shows the major natural resource exports in the region.

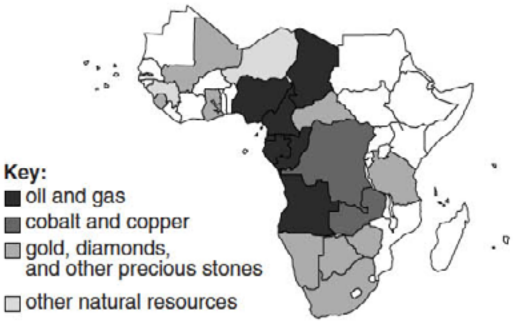

Fig. 5.1 – Major natural resource exports in sub-Saharan Africa

Rising world commodity prices, coupled with new resource discoveries, have stimulated growth in these economies during the past decade. Ensuring that these resources will lead to long-term economic development entails many policy challenges. Some of these challenges include the natural resource sector's tax/licensing regime and the state's role in the sector. Other policies will be needed to cope with declining government revenues as resources are depleted. Yet another set of policy concerns stem from the high volatility of resource prices. This volatility requires an appropriate framework for macroeconomic management because of the resulting large fluctuations in export revenues, budget receipts, and, in some cases, foreign direct investment (FDI).

Countries which export natural resources experienced faster economic growth than other SSA economies during 2000–12, but the improvement in their social indicators was not noticeably faster. Strong output growth following the discovery of natural resources changed the composition of output quite markedly among resource exporters, but the effect on the composition of employment has been modest. In part, this reflected the normally capital-intensive nature of resource production, but it also indicated the emergence of a sharply dualistic economic structure in which low-productivity sectors (such as agriculture and many services) remained largely untransformed. Gross National Income (GNI) per capita in SSA was, on average, higher in natural resource exporters than in non-resource exporters. This income advantage, however, was not reflected in significantly higher scores on the human development index (HDI).

Candidates could usefully undertake further research into the resource-rich economies of sub-Saharan Africa in order to produce a report on the policy challenges presented to these countries by their dependence on natural resource production.

As a follow up to the report on policy issues arising from dependence on natural resource production, candidates could discuss possible solutions to these problems and present their solutions in the form of posters.

PRE-RELEASE JUNE 2014

To be opened on receipt

A2 GCE ECONOMICS

F585/01/SM The Global Economy

STIMULUS MATERIAL

JUNE 2014

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- You should make yourself familiar with the stimulus material before you take the question paper. A clean copy of the stimulus material will be given to you with the question paper.

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- This document consists of **16** pages. Any blank pages are indicated.

Turn over

Introduction

The International Monetary Fund (IMF) has a number of roles and responsibilities, including surveillance. In 2012 the IMF concluded its annual assessment of the UK economy which, whilst supporting the UK Government's policy of austerity, made policy recommendations which it thought were necessary to secure a sustained economic recovery in the UK. These policy recommendations focused on the need to ensure that fiscal austerity did not reduce aggregate demand and hold back economic growth. The IMF thought that the UK output gap needed to be closed and was concerned that fiscal tightening might have a long term impact on the productive potential of the economy. It recommended that the UK Government should consider policies of balanced budget fiscal expansion and a loosening of monetary policy. The UK Government responded to this assessment of its economic policy by saying that expansionary policies should not conflict with the objectives of reducing the budget deficit and national debt. Later in 2012 the IMF published research which suggested that fiscal multipliers in a number of countries were much higher than previously thought and estimated these to be in the range of 0.9 to 1.7.

In comparison to its lukewarm support of fiscal austerity in the UK, the IMF was full of praise for the results of fiscal austerity in Latvia. IMF support for Latvia had previously been conditional upon a substantial tightening of fiscal policy. Despite Latvia operating a fixed exchange rate against the euro, the IMF claimed that Latvia had been able to restore its international competitiveness through cutting wages and prices. Fiscal austerity had helped achieve this improved international competitiveness through large cuts in public sector wages and the deflationary consequences of fiscal tightening on the private sector. The consequence was that, even though Latvia's nominal effective exchange rate (NEER) had been broadly stable, its real effective exchange rate (REER), adjusted for changes in unit labour costs, had depreciated by around 20% since the end of 2007. Not all economists, however, agreed that such 'internal devaluation' was the best way for an economy such as Latvia's to deal with its external imbalances. These economists drew a comparison with Iceland which operated a floating exchange rate. Its exchange rate had depreciated by 50% since the end of 2007.

Nevertheless, the IMF was strong in its support of Latvia's intention to adopt the euro. It felt that this would bring benefits to the Latvian economy in both the short run and the long run.

The trend towards fiscal austerity raised fears that the global economy was heading towards recession. The United Nations Conference on Trade and Development (UNCTAD) expressed a view that fiscal austerity in developed economies would put at risk the gains in economic development in the developing world through its impact on international trade. However, the experience of resource-rich economies in sub-Saharan Africa seemed to contradict this view. Commodity exports had grown strongly despite the downturn in economic growth in developed economies. Trade in commodities remained an important contributor to economic development for resource-rich economies in sub-Saharan Africa. Despite this, there were some concerns about the extent to which economic development in such economies could be promoted solely by a reliance on international trade.

Pre-release stimulus material

Extract 1: IMF surveillance report on the UK economy

Extract 2: Fiscal austerity and the UK output gap

Extract 3: IMF praise for fiscal austerity in Latvia

Extract 4: Latvia and Iceland – internal devaluation versus exchange rate devaluation

Extract 5: Economic development in resource-rich economies in sub-Saharan Africa

Turn over

Extract 1

IMF surveillance report on the UK economy

One of the IMF's main roles is 'surveillance'. This takes the form of an annual assessment of the economic situation in each member country. Officials from the IMF conduct a detailed analysis and then make forecasts of economic performance which are followed by in-depth discussions with a country's government and central bank. The IMF believes that such 'surveillance' encourages member countries to adopt sound economic policies.

The IMF's 2012 annual assessment of the UK made comments on the country's economic situation (Fig. 1.1). The IMF also made policy recommendations which it thought were necessary to secure a sustained recovery in the UK (Fig. 1.2).

1. **Current policies are aimed at assisting economic rebalancing and financial sector stability.**
   Strong fiscal consolidation is under way and reducing the high structural deficit over the medium term remains essential. The UK has made substantial progress towards achieving a more sustainable budgetary position and reducing fiscal risks. Bold monetary stimulus has helped support the economy, as has the free operation of automatic fiscal stabilisers.

2. **But the economy has been flat.**
   The rebalancing from public sector to private sector demand-led growth has not fully materialised. UK output remains more than four percentage points below its 2008 peak. Encouragingly, labour market performance has been better, with fewer employment losses than in the aftermath of previous major UK recessions. But unemployment at 8.2%, with a large number of young people without a job, is still much too high.

3. **The recovery is expected to gain pace, but much productive capacity could remain idle for an extended period.**
   Despite the projected modest increase in growth in the second half of 2012, the UK output gap is projected to remain sizeable for an extended period, raising the risk of hysteresis as sustained cyclical weakness may reduce the economy's future productive capacity.

4. **Inflation is falling.**
   Inflation has been on a downward trend since peaking in September 2011. This trend will continue as the large output gap exerts disinflationary pressure. Thus inflation is expected to decline below the two percent target over the next 18–24 months. This is dependent on an unchanged macroeconomic stance and an absence of a sustained increase in commodity prices.

5. **Risks are large and tilted clearly to the downside.**
   Setbacks in the euro area are the key risk to economic prospects and financial stability in the UK as trade and financial links are substantial. Another risk is that the adverse impact of measures to reduce public and private sector debt may be even larger than expected and the anticipated rebalancing of demand is even slower to materialise. Commodity price volatility also remains a risk for both inflation and growth.

Fig. 1.1 – Selected comments from the IMF on the economic situation in the UK

1. **Policies to bolster demand should help close the output gap faster.**
   It needs to be recognised that policy options in this regard come with risks, including uncertainty about their effectiveness. However, these risks need to be weighed against that of weak demand leading to long run slow growth, high unemployment and a negative impact on consumer and investor confidence.

2. **A more expansionary monetary policy is required via further quantitative easing and possibly cutting the interest rate.**
   Weak nominal wage growth and broadly stable inflation expectations suggest underlying inflationary pressure is weak, providing space for a more expansionary monetary policy.

3. **A more expansionary fiscal policy should be considered if downside risks materialise and the recovery fails to take off.**
   Balanced budget fiscal expansion should be pursued to increase growth. For example, cuts in spending on items such as public employee wages could be used to finance higher spending on items such as infrastructure.

Fig. 1.2 – Selected IMF fiscal and monetary policy recommendations for the UK

The IMF annual assessment of the UK's economic situation reignited debate about the effectiveness of the Coalition Government's Deficit Reduction Plan. There was a stark contrast between the statements of the Managing Director of the IMF, Christine Lagarde, and the UK Chancellor of the Exchequer, George Osborne.

"Unfortunately the economic recovery in the UK has not yet taken hold and uncertainties abound. The stresses in the euro area affect the UK through many channels. Growth is too slow and unemployment... is too high. Policies to bolster demand before low growth becomes entrenched are needed."

Christine Lagarde

"The IMF couldn't be clearer today. Britain has to deal with its debts and the Government's fiscal policy is the appropriate one and an essential part of our road to recovery. I welcome the IMF's continuing support for the UK Government's Deficit Reduction Plan."

George Osborne

Turn over

Extract 2

Fiscal austerity and the UK output gap

The first official estimate of UK Gross Domestic Product (GDP) for the second quarter of 2012 sharpened the focus on the UK's weak economic performance. Figures released by the Office for National Statistics (ONS) showed that GDP had declined by 0.7% between April and June. This represented the biggest quarterly fall in UK output since early 2009.

Predictably, some economists saw this as further evidence of a need for the UK Government to change the direction of economic policy away from austerity and towards the direct stimulation of economic growth. Others doubted the reliability of the estimates of GDP, pointing out that unemployment continued to fall, tax revenues were increasing and that business surveys showed rising rather than falling economic activity. They argued that the Government should not be distracted from its commitment to reduce the budget deficit and national debt. The head of the Organisation for Economic Co-operation and Development (OECD), Angel Gurria, echoed the assessment of the IMF that measures to promote growth should concentrate on balanced budget fiscal expansion.

The extent of the UK's weak economic performance can be seen in Fig. 2.1. This compares the change in GDP from the start of the 2008 recession with the next most recent recession (1990–93) and what is considered to be the worst recession (1930–34).

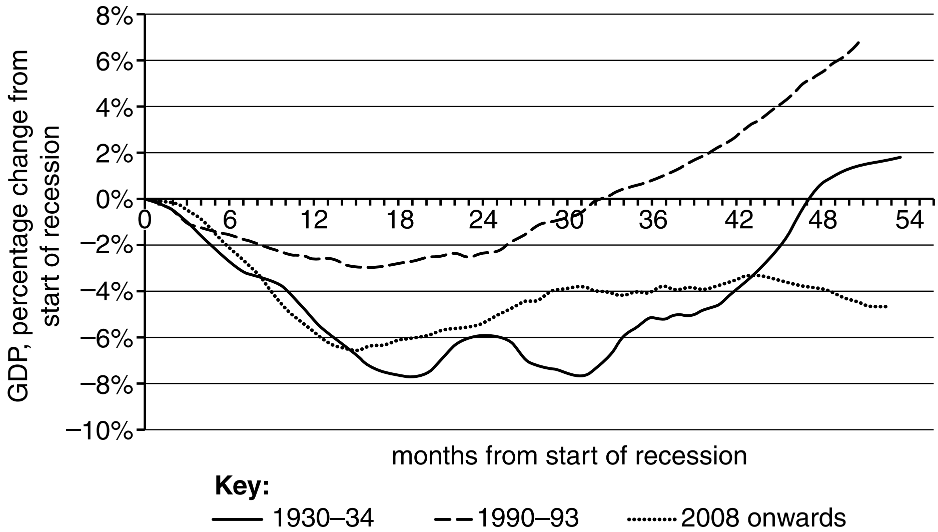

Fig. 2.1 – A comparison of the change in GDP in three UK recessions

The case for more fiscal and monetary stimulus would be a strong one if the UK output gap was large. In all previous recessions, UK output had returned to its pre-recession level within 48 months of the start of the recession. This was clearly not the case with the recession which started in 2008. There was agreement that the UK's output gap in 2012 was negative. However, estimates of the size of the output gap varied from –2.5% of GDP (Office of Budget Responsibility) to –9% of GDP (Centre for Business Research, University of Cambridge).

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Extract 3

IMF praise for fiscal austerity in Latvia

In December 2008 the IMF announced plans to lend €1.7 billion to Latvia to help to stabilise its economy. This financial assistance was supplemented by loans from the European Union (EU), the World Bank and several Nordic countries to provide a package totalling €7.5 billion. The assistance was part of an agreement to defend Latvia's currency peg to the euro (a fixed exchange rate) and the country's commitment to join the euro. The Latvian currency, the lat, had come under pressure as a result of a current account deficit on the balance of payments of almost 25% of GDP in 2007. This deficit was financed by increasing levels of private sector external debt. The credit and growth boom that followed Latvia's accession to the EU simply could not be sustained. Very high wage growth, far in excess of productivity growth, had severely undermined Latvia's international competitiveness and contributed to the economy's large external imbalances. Latvia was once the fastest growing economy in the EU. By the end of 2008 it was the worst-performing economy.

In exchange for financial assistance from the IMF and other lenders, Latvia agreed to a 'strong package of policy measures' including:

- large cuts in public sector wages
- substantial tightening of fiscal policy
- structural reforms to raise international competitiveness.

IMF staff visited Latvia in May 2012, as part of its surveillance role, in order to monitor the outcome of its programme of assistance and the policy measures adopted by the country. In a press release, the IMF concluded that:

"The Latvian authorities have made good progress toward the programme's strategy of euro adoption. Impressive fiscal consolidation during the programme means the Maastricht fiscal criteria should be easily met. Joining the euro would be beneficial for the Latvian economy."

The IMF's assessment of the outcome of its programme of assistance and the policy measures adopted by Latvia were held up as examples of the success of fiscal austerity measures. Latvia had rejected devaluation of the exchange rate in place of a policy of 'internal devaluation' to restore international competitiveness. Latvia is one of four economies, known as the BELLs (Bulgaria, Estonia, Latvia and Lithuania), which adopted and stuck to a fixed currency peg with the euro and have been regarded as success stories of fiscal austerity. The fiscal tightening in Latvia initially produced a loss of output of around 20% and an increase in unemployment from 6% to 18.4%. However, by 2011 the country's current account deficit had become a surplus and GDP growth, at 5.5%, was one of the highest in the Europe.

In a speech in Riga, Latvia's capital, in June 2012, Christine Lagarde, Managing Director of the IMF, was full of praise for the country's policy of austerity. She praised the Latvian government's economic policy as a "success story" that "could serve as an inspiration for European leaders grappling with the euro crisis". Fig. 3.1 gives extracts from her speech.

It is a great pleasure to be here today in this beautiful city of Riga to celebrate the remarkable achievements of Latvia over the past few years.

Let me begin with the context. As you all know too well, Latvia has been tested severely over recent years. It lost a fifth of its output in just two years, 2008 and 2009. Unemployment rose to almost 20%, and double this rate among young people. Poverty increased and people from all walks of life endured great suffering.

And yet, while challenges remain today, you have pulled through. You have returned to strong growth and reduced unemployment, even if it remains far too high at around 16%. You have lowered budget deficits and kept government debt ratios to some of the lowest in the European Union. You have become more competitive in world markets through wage and price cuts. You have restored confidence and brought down interest rates through good macroeconomic policies.

How did you do it?

If we want to single out one factor for Latvia, it would be its impressive determination. This had a number of dimensions:

- *instead of spreading the pain over many years, the country stood together and did what needed to be done up front. The achievement was incredibly impressive – in the first year of its programme, Latvia implemented fiscal adjustment of more than 8% of GDP. Total adjustment for the whole programme is even higher, at around 15% of GDP.*
- *Latvia also had a clear goal: euro adoption. This meant that everybody knew where they were going, and Latvia has stayed the course.*
- *to cushion the hardship, the government agreed to protect the poorest and most vulnerable people by strengthening the social safety net. So, even in an atmosphere of major budget cuts, Latvia expanded and improved unemployment assistance.*

Speaking for the IMF, I am proud to have been part of Latvia's success story, alongside our European Commission and Nordic partners.

Fig. 3.1 – Selected quotes from a speech by Christine Lagarde

Extract 4

Latvia and Iceland – internal devaluation versus exchange rate devaluation

Some economists are sceptical about the success of Latvia's internal devaluation in delivering a sustained economic recovery and correcting external imbalances.

Although Latvia's GDP has grown since 2010, it is not clear that such growth can be sustained. This is because of the sharp change in the composition of GDP growth which has resulted from internal devaluation. High levels of private sector indebtedness remain in Latvia and, as a result, growth in both investment and consumer expenditure remain weak (see Fig. 4.1). Fiscal tightening has limited the contribution of government expenditure to GDP growth. Latvia's economic growth is, therefore, very heavily dependent on growth in net trade. Whether Latvia can sustain economic growth solely from exports depends not only on the growth in world trade but also on Latvia's international competitiveness.

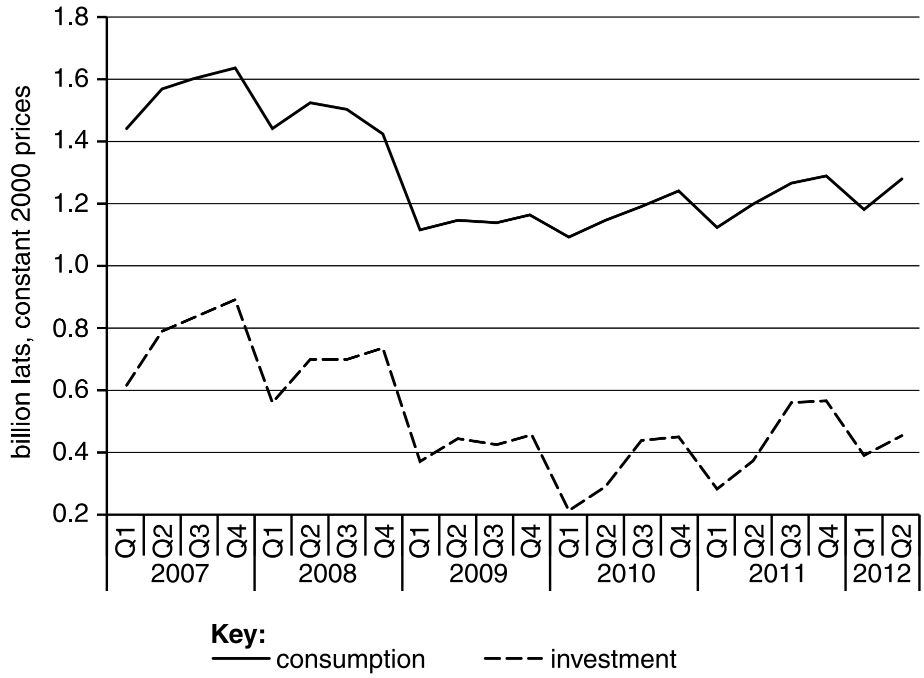

Fig. 4.1 – Latvian investment and consumer expenditure (billion lats, constant 2000 prices)

Internal devaluation puts downward pressure on nominal wages and prices and has been responsible for restoring some of Latvia's international competitiveness which was lost prior to 2007. However, most of the reduction in nominal wages occurred in the public sector and not in the private sector. In addition, for reductions in unit labour costs to be sustained, there needs to be improvements in productivity as well as a reduction in nominal wages. The improvement in Latvia's current account balance has been short lived. The surplus recorded in 2010 disappeared and by 2012 a deficit on the current account re-emerged.

Economists who are sceptical about the success of Latvia's internal devaluation in delivering a sustained economic recovery and correcting external imbalances draw a comparison with the experience of Iceland. Unlike Latvia, Iceland has a floating exchange rate. Iceland's nominal effective exchange rate (NEER) index depreciated by almost 50% after the end of 2007. In comparison, Latvia's NEER was broadly unchanged (see Fig. 4.2). Latvia was more dependent on a change in its real effective exchange rate (REER), which depreciated by around 20% measured in terms of unit labour costs. This compares to a 45% depreciation in Iceland's REER based on changes in unit labour costs. In addition, Iceland's fiscal tightening was not as aggressive as Latvia's. Fig. 4.3 shows the different outcomes from 2007 until 2012 in the two economies of the different approaches to the problem of external imbalances.

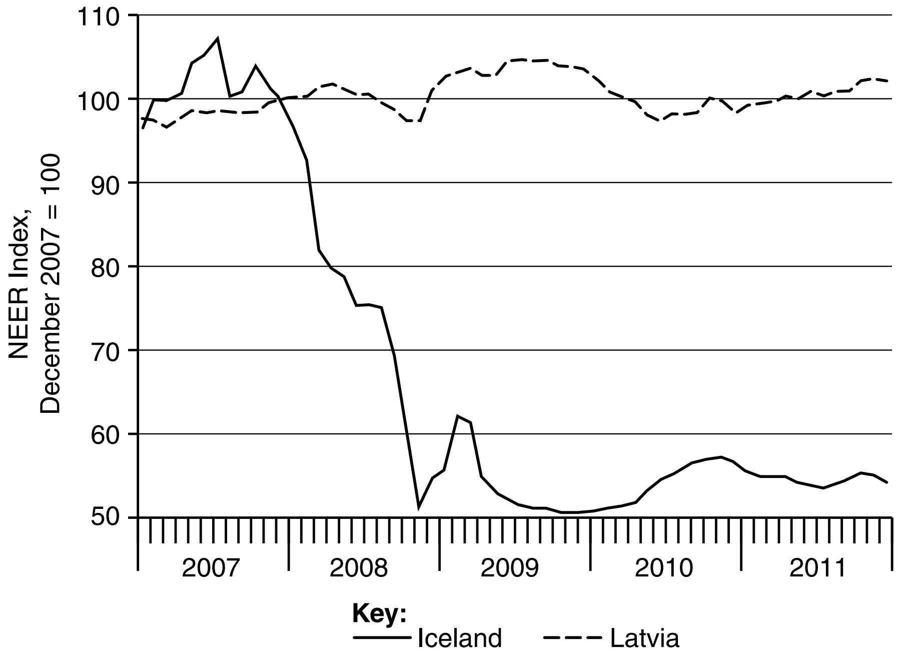

Fig. 4.2 – Nominal Effective Exchange Rate Indices for Iceland and Latvia, 2007–11

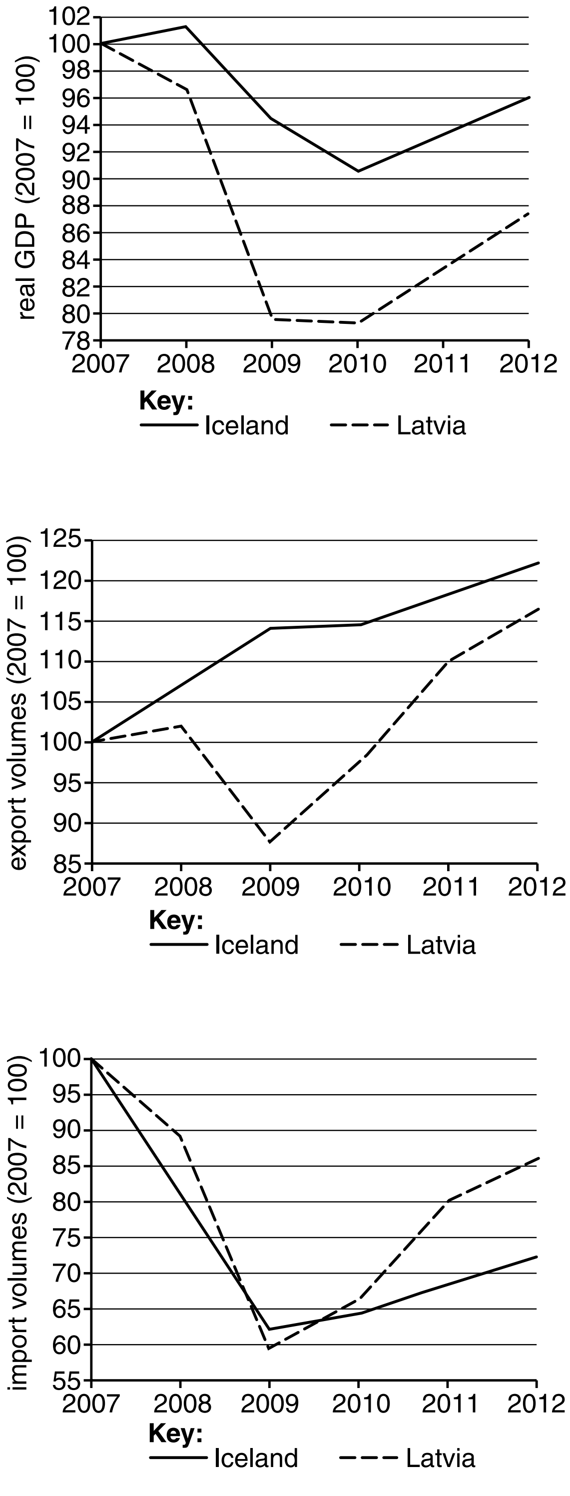

Fig. 4.3 – A comparison of key economic indicators in Iceland and Latvia, 2007–12

Extract 5

Economic development in resource-rich economies in sub-Saharan Africa

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This contrasted with an assessment by the IMF in April 2012 of the economic outlook in sub-Saharan Africa (SSA). According to the IMF the fall in economic activity in Europe had not had a significant impact on growth in most of SSA. This was because most countries in SSA had diversified their exports to emerging markets and intra-regional trade had increased. In addition, around 80% of exports from SSA were commodities. Between 2005 and 2010 the region's commodity exports had grown in total by 16.6%, but exports of commodities to Europe had only grown by 2.6%.

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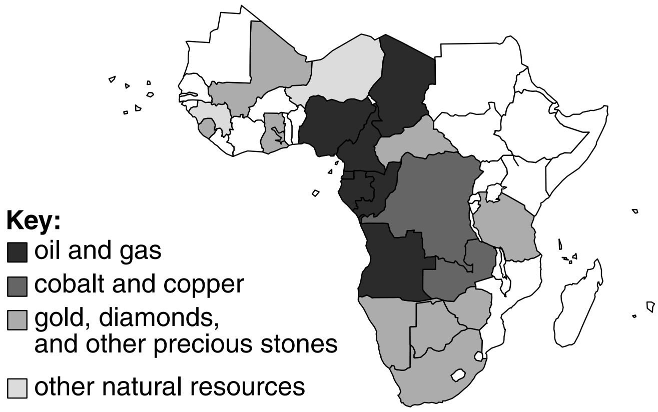

Fig. 5.1 – Major natural resource exports in sub-Saharan Africa

Rising world commodity prices, coupled with new resource discoveries, have stimulated growth in these economies during the past decade. Ensuring that these resources will lead to long-term economic development entails many policy challenges. Some of these challenges include the natural resource sector's tax/licensing regime and the state's role in the sector. Other policies will be needed to cope with declining government revenues as resources are depleted. Yet another set of policy concerns stem from the high volatility of resource prices. This volatility requires an appropriate framework for macroeconomic management because of the resulting large fluctuations in export revenues, budget receipts, and, in some cases, foreign direct investment (FDI).

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